CIO Memo

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Silicon Valley Bank: Bank-run on the Tech sector?

Key takeaways

- Last Friday saw the California-based bank Silicon Valley Bank (SVB) closed by U.S. regulator Federal Deposit Insurance Corporation (FDIC) following significant withdrawals of deposits to the total sum of $42bn.
- The bank had spent previous days attempting to raise funding to cover losses from its bond portfolio which was exposed to both long dated bonds and fixed rate investments.
- Market volatility dramatically spiked over the course of Friday with U.S. regulators working to assess what protections are in place for depositors as well as any potential systemic risk to the financial system.

1. What happened?

California-based bank Silicon Valley Bank (SVB) were declared insolvent by U.S. regulator Federal Deposit Insurance Corporation (FDIC) following significant withdrawals from the banks deposit holders. By the close of Friday SVB had $42bn, a quarter of its total deposits, withdrawn in one trading day. The closure of the regional bank became the second-largest bank failure in U.S. history.

Concerns around the solvency of the SVB arose when the bank attempted to raise $2.25bn in additional capital the previous day in order to strengthen its balance sheet from already increasing deposit withdrawals from its customer base. By this stage, a U.S. based Private Equity firm had agreed to buy $500m of stock.

The decision to raise capital through an equity sale was also driven by concerns around the banks rather concentrated balance sheet consisting of long-dated fixed income securities including U.S. Treasuries and fixed rate mortgage-backed securities. Given the liquidity requirements, the bank was forced into selling $21bn of these assets, known as “available-for-sale” securities, at a $1.8bn loss.

Another, somewhat unique characteristic of SVB, was its also highly concentrated client base which consisted predominantly of Venture Capital (VC) backed technology firms. Playing such an outsized role for a niche client base saw cash deposits dramatically increase in recent years as the technology sector saw exponential growth and SVB benefitted from their VC-backed clients depositing funds with them. With more deposits than they could lend out, the bank decided to invest these funds in long dated Treasuries in a search for more attractive yields.

Given the long duration nature of these securities, SVB was exposed significantly to the Federal Reserve’s decision to aggressively raise the Fed Funds Rate over the last 12 months in order to tackle inflation. Combined with the increased use of cash deposits by their start-up tech firms to manage their day-to-day operations, this caused a liquidity mismatch for the bank.

2. How did markets react?

Markets reacted negatively to the breaking news surrounding SVB with strong selling seen within the financial sector as investors concerns around risk contagion rose. Both the S&P 500 and NASDAQ closed the day down -1.45% and -1.76% respectively. Within Fixed Income, Treasury yields fell considerably with the yield curve steepening. The 2-Year Treasury yield fell 31 basis-points to reach 4.58%.

Focus moved quickly to the potential U.S. regulators response following its takeover of SVB. Current estimates are that over 95% of SBV’s deposits are not insured by FDIC’s $250,000 per deposit protection with expectations of an asset-sale to help provide additional funds to assist existing customers.

3. What does it mean for investors?

As mentioned by Treasury Secretary Janet Yellen on Sunday morning, the U.S. banking system is safe and well-capitalized. The big question for investors is whether the SVB collapse is an idiosyncratic event given the uniqueness of its business model or is it the start of an industry wide contagion. Near term market reaction is dependent on the actions taken by the Federal Reserve and Treasury Department.

As per FDIC, the depositors will have access to their deposits no later than Monday morning (March 13th). Treasury Secretary Yellen has ruled out a “bail-out” which leaves the true nature of deposit protection unclear.

Overall, the most direct impact would be on small-mid cap regional banks that have a similar business model to SVB (concentrated deposit funding and carrying large unrealized losses). How much of a depositor run we see on those banks in upcoming days could determine the scale of the problem. Additionally, many companies operating withing in the tech industry who have deep banking relationship with SVB could come under investor scrutiny as well.

Silicon Valley Bank’s collapse could have far-reaching consequences within the regional banking and tech VC space. It is too early to gauge and define the extent of a broader financial contagion. Larger, more systemically important banks are in a stronger position given their diversified balance sheets. As of now we expect financial regulators to step in and produce a plan of action as market volatility is expected to persist.

The SVB saga has reaffirmed our cautious stance on risky assets, especially in the U.S. as markets continue to reprice Fed’s actions with regards to its rate hiking cycle. SVB is as of now the most visible and painful side effect of one of the fastest rate hiking cycles that the Fed has embarked on. However, questions could certainly be asked concerning the risk management decisions taken by the California based firm, regarding its asset-liability practices in particular.

Glossary

The Federal Deposit Insurance Corporation (FDIC) is a United States government corporation supplying deposit insurance to depositors in American commercial banks and savings banks.

The Fed funds rate is the interest rate at which depository institutions lend overnight to other depository institutions.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

The NASDAQ index is a market-capitalization weighted index of around 3,000 equities listed on the Nasdaq exchange.

Private equity refers to funds or individuals investing directly in private, non-listed companies.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are bonds issued by the U.S. government.

USD is the currency code for the U.S. Dollar.

Venture capital (VC) is a type of private equity financing, typically to small, early-stage, emerging firms.

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